Docket No. 00-0476
ICC Staff Exhibit 9.0

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REBUTTAL TESTIMONY

OF

ROCHELLE LANGFELDT

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY
CITIZENS UTILITIES COMPANY OF ILLINOIS

DOCKET NO. 00-0476

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Q. Please state your name and business address.

A. My name is Rochelle Langfeldt and my business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. Are you the same Rochelle Langfeldt who previously testified in this proceeding?

A. Yes, I am.

Q. Please describe the purpose of your testimony.

A. The purpose of my rebuttal testimony is to comment on the rebuttal testimony of Company witnesses Messrs. Gloriod, Hartnett, Hamilton, and Mülle , who testified on behalf of Illinois-American Water Company ("IAWC" and "Company") regarding the Acquisition by IAWC of the Utility Assets. [1,2]

Q. The direct and rebuttal testimonies of Commission Staff and Company witnesses have used the terms "acquisition adjustment", "merger", "acquisition", "merger premium", and "acquisition premium". To clarify, please define these terms as used in your testimony.

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[1] The term "Acquisition" refers to the Acquisition transaction in which IAWC entered into an asset purchase agreement with American Water Works, Inc. ("AWW" and "Parent"), Citizens Utilities Company ("CUC" and "Citizens"), Citizens Utilities Company of Illinois ("CUCI") and certain other affiliates of Citizens under which IAWC will purchase from CUCI the Utility Assets.

[2] Utility Assets, as defined in the Company's Amended Verified Application, refers to both the water and wastewater assets of CUCI and certain business assets of Citizens Business Service Company ("CBSC").

A. As defined in Staff witness Thomas Q. Smith's direct testimony, for ratemaking purposes, the difference between the purchase price and the net original cost ("book value") of the acquired assets is generally referred to as a plant acquisition adjustment.[3]

Both mergers and acquisitions involve the change in control of assets for which a premium may be paid. Specifically, a merger is defined as, "(1) Acquisition in which all assets and liabilities are absorbed by the buyer (cf. Exchange of assets, exchange of stock); (2) more generally, any combination of two companies."[4] As such, I consider the terms "acquisition" and "merger" to be equivalent terms and I consider the terms "acquisition premium" and "merger premium" to be equivalent terms throughout my testimony.

Q. Mr. Hamilton defines "acquisition premium" as the difference between the price paid and the book value of the Utility Assets.[5] Is this definition of acquisition premium correct?

A. From a financial standpoint, merger premiums are mathematically expressed as the difference between the price paid for a company and its market value immediately preceding the acquisition announcement ("market value"). This

[3] Staff Exhibit 1.0, lines 120-131.
[4] Brealey, Meyers. Principles of Corporate Finance, 6th edition, p. 1068.
[5] Company Exhibit 7.0R, page 13, lines 13-15.

definition was used in Docket No. 95-0551, where a merger premium was expressed as the purchase price less pre-acquisition market value.[6]

The market value represents the most that investors buying non-controlling interests ("minority shareholders") would pay for the company in aggregate since he or she would not have the power necessary to change operations in a way that would change the pre-merger cash flows.[7] Because merger premiums arise from merger and acquisition transactions ("M&A transactions") that involve the change in control of a company, merger premiums can also be described as the additional price paid for a controlling interest in comparison to the aggregate market value of that company to minority shareholders. In effect, the merger premium represents the maximum amount of wealth transfer from IAWC to CUCI common shareholders should IAWC not recover the merger premium through rates.

Q. Do you agree with Mr. Gloriod's opinion that a lower premium, resulting from calculating the merger premium as purchase price, less market value, would reduce the opportunity for recovery on the investment made to the extent it is detrimental to the shareholders?[8]

[6] Order, Docket No. 95-0551, September 10, 1997, p. 17.
[7] This statement is based on the Discounted Cash Flow model ("DCF model") which maintains that the value of a given asset is equal to the present value of the assets' expected future cash flows.
[8] Company Exhibit 1.0R, page 8, lines 15-17.

A. I agree that the higher the rate a utility can charge, the greater the probability it will recover its investment and more. Nevertheless, ratemaking is a process of balancing ratepayer and investor interests. That balance would not be achieved if a utility is permitted to recover more than its true cost of service.

When the IAWC shareholders agreed to the Acquisition, under the terms of the Asset Purchase Agreement, they effectively agreed to a price for the control of the Utility Assets. If they agree to a purchase price for the Utility Assets that is too high, based on the expected future cash flows to be generated by the Utility Assets, they will suffer an economic loss. Nevertheless, the purchase price to paid for the Utility Assets remains the decision of the Company and its shareholders. Therefore, if the Company would not have a reasonable opportunity to recover its investment without resort to charging ratepayers for an inflated estimate of the merger premium, then it agreed to pay too much for the Utility Assets.

Q. Do you agree with Mr. Mülle's characterization of pre-acquisition market value as being difficult to determine?[9]

A. Certainly, in relation to book value, market value for a company with non-market-traded common stock would be more difficult to measure. Nevertheless, the

[9] Company Exhibit 8.0R, page 16, line 8.

precision inherent in book value measurement does not overcome the inaccuracy it would cause in merger premium measurement.

Despite the difficulties inherent in measuring market value, AWW not only estimated the expected pre-merger cash flows of the CUC companies it intends to acquire in its DCF analysis of the Project, but the Parent estimated the expected operational savings that would result from the Project and used this as a basis for determining a purchase price. Although measurement error is bound to occur in reasonable forecasts, by including cash flows that are expected to result from operational synergies that do not exist at this time and predicting the cash flows to be generated by such means into a 40 year horizon, the Company has taken on even greater difficulties than it would in estimating the pre-merger market value of the Utility Assets.

Q. Under what circumstances is it necessary for the Commission to rule on the amount of the merger premium?

A. My understanding is that IAWC must correctly measure the merger premium to satisfy the requirement of Section 7-204(b)(7) of the Public Utilities Act ("Act"), which states, "The proposed reorganization is not likely to result in any adverse rate impacts on retail customers."[10] If the Commission were to allow a merger premium to be reflected in IAWC's rates, via the Company's Savings Sharing

[10] 220 ILCS 5/7-204(b)(7)

Proposal ("SSP") or the Alternative Proposal, the merger premium must be measured correctly; otherwise, ratepayers would be charged rates that do not accurately reflect the actual merger premium portion of the purchase price. This results in an adverse rate impact to Illinois ratepayers. However, if the Commission rejects the Company's proposal to allow a merger premium to be reflected in IAWC's rates, as recommended by Staff witnesses Thomas Q. Smith and Dave Borden, the Commission need not rule on the amount of the merger premium.[11]

Q. Please respond to Mr. Hamilton's statement that the market value of CUCI would equal book value if regulators permitted cash flows based solely on the original cost of the Utility Assets.[12]

A. Mr. Hamilton's statement is based on the incorrect premise that regulation is perfect and based purely on original cost and actual cash flows. Unless the market-to-book ratio for CUCI is one, and there is no evidence of such, the appropriate measure of a merger premium would be the purchase price less the pre-merger market value of the Utility Assets because the pre-merger market value reflects the pre-merger earnings and cash flow of the Utility Assets.

Q. Messrs. Hartnett and Mülle do not believe that a company would be overcompensated with additional cash flow if a merger premium is

[11] Staff Exhibit s 1.0, page 14, lines 314-317 and 5.0, page 2, lines 31-32.

calculated using a book value that is less than the market value of those same assets.[13] Do you agree?

A. No. A company's market value should be used as the baseline in calculating a merger premium as the market value represents the present value of future cash flows a company is currently expected to generate, even without merger-induced changes in operations. The market value represents the highest price that minority shareholders would be willing to pay for the assets of the company since minority shareholders would not be able to affect the pre-merger cash flows by changing the company's operations. In other words, CUCI will generate a certain level of cash flow under current rate-setting procedures and without merger premium recovery and sharing of merger savings. If the present value of those cash flows exceed book value, as it does for market-traded water companies, then the Company would be compensated for the same cash flows twice. Therefore, the Company would realize cash flows above and beyond the level that was already supporting the market value of the assets without rate recognition of a merger premium.

Q. Has the Commission previously ruled on the compensating a utility for an acquisition premium as Messrs. Mülle and Hartnett define it?

A. Yes. In Docket No. 97-0351, Consumers Illinois Water Company ("CIWC") alleged that CIWC's market value of common equity exceeded the book value of

[12] Company Exhibit 7.0R, page 13, lines 11-13.

common equity. In other words, minority shareholders were willing, or would be willing, to pay a premium to acquire an interest in water utilities in general, and CIWC in particular, relative to book value. In consequence, CIWC recommended that it be allowed a return on book value in excess of the investor-required return on market equity to compensate minority shareholders for this acquisition premium. The Commission rejected CIWC's recommendation.[14]

Q. Is Mr. Hartnett correct in his statement that a "cycle" of increasing value is impossible under the SSP because the SSP limits the premium to be recovered from customers to the amount of costs that can be eliminated as a result of the acquisition?[15]

A. No. The additional cash flows realized through recognizing the pre-merger portion of a merger premium in rates would further increase the market value of the assets, without affecting their book value. That is, minority shareholders would be willing to pay a higher price for the underlying assets since the assets would generate even greater cash flows. The problem becomes circular as the increased market value of the assets would lead to a higher "merger premium," in relation to book value, which, if reflected in rates, would increase cash flows. In summary, recovery of the premium increases rates, which increases the amount of cash flows the assets will generate, which further increases the

[13] Company Exhibit 4.0R, page 3, line 19 through page 4, line 5 and Company Exhibit 8.0R, page 15, lines 20-24.
[14] Order, Docket No. 97-0351, June 17, 1998.
[15] Company Exhibit 4.0R, page 4, lines 13-15.

market value of the assets, which further increases the premium, causing the cycle to continue.

Q. Mr. Hartnett states, "the assumption that AWW would retain the economic equivalent of 100% of the savings resulting from the acquisition was made to determine the level of purchase price which the expected savings could support".[16] Was this a reasonable assumption to make in negotiating the purchase price for the Utility Assets?

A. No. The Company assumed regulatory treatment would allow the Company to either retain the savings or recognize in rates the premium paid, to the extent the premium is offset by the savings. However, there is no logical basis for the Company to assume that the ratepayers would be charged for a premium that has no effect on merger savings and which resulted from negotiations in which ratepayers did not participate.

As I stated previously, AWW assumed that it would retain the economic equivalent of 100% of the savings resulting from the acquisition in order to determine the level of purchase price that the expected savings could support. Thus, the merger premium is a function of the portion of merger savings which investors expect to retain. Since the merger premium is a function of merger savings investors expect to retain, in this instance, 100%, the Commission's

[16] Company Exhibit 4.0R, page 5, lines 11-18.

permission to directly recover the merger premium through the SSP or the Alternative Proposal would justify higher merger premiums from the utility's standpoint.

If, in this proceeding, the Company's shareholders were allowed to recover 100% of the merger premium through ratepayers, the result would reduce incentive for the Company to minimize merger premiums in future acquisitions. This would occur because shareholders would be willing to authorize the Company to pay a higher purchase price in future acquisitions since shareholders would expect to be able to recover subsequent merger premiums from ratepayers. Allowing IAWC to recover a portion of the merger premium through ratepayers would, effectively, reduce risks to shareholders associated with acquisitions.

Q. Mr. Hamilton maintains that as long as the principle that recovery of a merger premium should result in no net cost increase to customers is the standard, there is a limit to what an acquirer would be willing to pay for the Utility Assets (i.e., the cost savings expected to result from a merger should be the absolute ceiling on the recovery of the premium).[17] Will this standard serve as a useful ceiling for the recovery of merger premiums?

[17] Company Exhibit 7.0R, page 11, line 11 through page 12, line 9.

A. No. Mr. Hamilton refers to this as the "no net cost to the customer standard" and believes this logic will provide checks and balances to the amount of a merger premium that a company can pay and expect to collect through rates. However, under this standard, allowing a merger premium to be reflected in rates could have the undesirable effect of increasing future merger premiums and reducing merger savings net of the merger premium. Even if the Acquisition results in savings (i.e., reduced operational expenses), and these savings are passed through to ratepayers, net of the premium paid to execute the Acquisition, ratepayers would realize a reduced level of savings due to the inclusion of a portion of the premium paid in rates. In future acquisitions, premiums could increase due to the recognition of premium in utility rates in previous cases since acquirers would have greater certainty of premium recovery. As a result, savings, net of the premium, would decrease.

Q. Does the allocation of the purchase price among the State jurisdictions involved in the Project and the allocation of the purchase price for the Utility Assets demonstrate that the proposed reorganization will not unjustly subsidize non-utility activities, as required by Section 7-204(b)(2) of the Act?[18]

A. No. Per Section 7-204(b)(2) of the Act, "In reviewing any proposed reorganization, the Commission must find that the proposed reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its customers."[19] Mr. Hartnett attests that AWW had to determine an offer price and had to allocate the price as fairly as possible. AWW found Gross plant, property and equipment ("Gross PP&E") to be the most logical basis. As such, Mr. Hartnett claims that the allocated price for the Utility Assets is fair and reasonable and does not cause a violation of Section 7-204(b)(2) of the Act.

Gross PP&E is not a proper method for allocating the purchase price of the Project because it does not incorporate the present value of the cash flows, including merger savings, of each CUC company IAWC will acquire. Gross PP&E does not even distinguish amongst the various jurisdictions on the basis of the proportion of utility assets that customers have already paid for through utility rates. Further, no single allocation method was used in determining the allocation of the purchase price for the transactions occurring in the Illinois jurisdiction. The purchase price for the Utility Assets was established from a highly questionable allocation of total purchase price for the Project to the various companies included in the Acquisition because the allocation methodologies that AWW and IAWC employed fail to establish the value of the underlying assets. Therefore, they are arbitrary in nature.

[18] The term "Project" refers to AWW, and certain affiliates, acquiring all of the water and wastewater assets of certain subsidiaries of CUC.
[19] 220 ILCS 5/7-204(b)(2).

My understanding is that the proposed allocation of the purchase price amongst State jurisdictions and between utility and non-utility activities must satisfy Section 7-204(b)(2) of the Act and that "non-utility activities" include the unregulated utility operations within Illinois and regulated and non-regulated utility operations outside of Illinois.[20] AWW and IAWC fail to meet this criterion due to the highly subjective manner in which they allocated the purchase price of the Project and the Utility Assets, respectively. Since the Company seeks to include the premium in rates, if AWW allocated too much of the purchase price to IAWC, then IAWC ratepayers would be subsidizing non-utility operations inside and outside of Illinois.

Q. Please comment on IAWC's DCF analysis of the market value of the Utility Assets.

A. In its rebuttal testimony, the Company submitted an Illinois-specific DCF analysis for the Utility Assets ("Illinois DCF analysis"), which produced a value of $221 million.[21] This value is stated in terms of enterprise value, including the impact of the identified operational savings that the Company expects to result from the Acquisition ("EV").[22] According to Mr. Hartnett, this value compares favorably to the allocated purchase price of $219 million in the Asset Purchase Agreement.[23]

[20] 220 ILCS 5/3-105.
[21] Company Exhibit 4.1R.
[22] According to Company response to data request RL 5.02, attached to ICC Staff Exhibit 3.0 as Schedule 3, enterprise value is defined as, "The sum of market value of the common equity, preferred equity and short and long-term debt, less cash and cash equivalents."
[23] Company Exhibit 4.0R, page 8, lines 13-15.

However, I immediately recognize three problems with the Illinois DCF analysis that make it impossible to rely on the Illinois DCF analysis as a reliable and accurate depiction of the Utility Assets' value. Foremost, the $221 million value for the Utility Assets is stated in terms of EV. This value is not representative of the allocated purchase price for the Utility Assets as a portion of the Project purchase price of $835 million. Rather, the Utility Assets' EV is equivalent to the estimated EV for the Project DCF analysis.[24] Second, the Illinois DCF analysis includes $21 million in expected future cash flows described as "Present Value of Tax Benefit of Goodwill Amortization". The expected cash flows resulting from this tax benefit are not included in the Company's Project DCF analysis. Inclusion of these cash flows in the Illinois DCF analysis makes it impossible to compare the Project DCF analysis to the Illinois DCF analysis. Finally, the amount of annual savings shown in Company Exhibit 3.1R is not equal to the annual savings shown in the Illinois DCF analysis.

While DCF analysis is the most appropriate method for measuring merger premiums, the method is only as reliable and accurate as the inputs used. Based on these problems alone, the Illinois DCF analysis is neither a reliable nor an accurate measure of the market value of the Utility Assets.

[24] The Project DCF analysis is included in Attachment 4(c)-12 of Company response to data request Staff 1.02. The Attachment is attached to ICC Staff Exhibit 3.0 as Schedule 5.

While IAWC did conduct an Illinois-specific DCF analysis, Mr. Hartnett did not deem it necessary to calculate the ratio of the Project's purchase price to its post-acquisition market value to allocate the purchase price of the Utility Assets.[25] However, to properly allocate the purchase price of the Utility Assets, it would be necessary to calculate the ratio of the Project's purchase price to its post-acquisition market value. A fair purchase price for the Utility Assets compared to the Utility Assets' post-acquisition market value would be proportionate to the purchase price of the Project compared to the Project's post-acquisition market value. Otherwise, Illinois ratepayers could be required to pay for a disproportionate share of the merger premium.

Q. As Mr. Hartnett indicates, acquisition multiples are commonly used by analysts in the security industry.[26] In light of this fact, do the acquisition multiples presented by Mr. Bobba in Company Exhibit 6.3 demonstrate that the purchase price for the Utility Assets is reasonable in comparison to other transactions in the market?

A. No. Although acquisition multiples may serve as useful valuation benchmarks, a valuation "benchmark" does not indicate whether the purchase price allocation is fair. Acquisition multiples should be used and interpreted with extreme caution because (1) each acquisition is unique, (2) buyers and sellers do not know all the

[25] Company Exhibit 4.0R, page 6, lines 1-3.

factors and motives that are involved in the formulation of another acquisition price, and, (3) there are several types of acquisition multiples, each with different purposes and limitations.[27] Due to both Mr. Bobba's limited knowledge of the details involved in the M&A transactions he highlights in Company Exhibit 6.3 and the vague nature of acquisition multiples, Mr. Bobba's analysis is not sufficient for demonstrating the purchase price of the Utility Assets is reasonable in light of recent market data.

Q. What is the basis for your assertion that Mr. Bobba's knowledge of the M&A transactions he highlights in Company Exhibit 6.3 is limited?

A. Company response to data request RL 3.07 indicates Mr. Bobba considers the facts surrounding the Acquisition and the facts surrounding the acquisition transactions shown in Company Exhibit 6.3 are similar in at least three respects: (1) all of the transactions are acquisitions in the same industry; (2) the transactions occurred within the same period of time; and, (3) all of the transactions were adjusted to reflect an asset purchase (emphasis added).[28] However, Company response to data request RL 5.03 indicates that there are no other factors Mr. Bobba considered, other than the three already identified in Company response to data request RL 3.07, that led him to conclude that the facts surrounding the Acquisition and the facts surrounding the M&A transactions shown in Exhibit 6.3 are similar (emphasis added). Regarding the M&A

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[26] Company Exhibit 4.0R, page 7, lines 2-6.

transactions highlighted in his analysis, Mr. Bobba considers neither the value for control of a company nor the level of savings the acquirer expects to realize.[29] His analysis considers neither the underlying assumptions of the acquirer regarding retention of the savings nor regulatory commission recognition of a merger premium.[30] Therefore, Mr. Bobba's analysis is insufficient for determining the reasonableness of the purchase price IAWC would pay for the Utility Assets of CUCI.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

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[27] Case, Shah and DePass. Financial Strategy and Policy, page 15.
[28] Company response to data request RL 3.07 is attached to ICC Staff Exhibit 3.0 as Schedule 9.
[29] Company response to data request RL 3.08 is attached to ICC Staff Exhibit 3.0 as Schedule 6.
[30] Company response to data request RL 3.09 is attached to ICC Staff Exhibit 3.0 as Schedule 11.